

9-1-1976

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Recommended Citation

Henry M. Mercer, *Income Taxation -- A Pauper a Day Keeps the Taxman Away: Qualification of Hospitals as Charitable Institutions under Section 501(c)(3) of the IRC of 1954*, 54 N.C. L. REV. 1195 (1976).

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COMMENTS

Income Taxation—A Pauper a Day Keeps the Taxman Away: Qualification of Hospitals as Charitable Institutions Under Section 501(c)(3) of the IRC of 1954

Public policy is the aggregate of the "general principles by which a government is guided in its management of public affairs. . . ."¹ This expression of concern for "the welfare or prosperity of the . . . community"² is found in our constitutions, statutes, judicial decisions, and executive orders. Nowhere is public policy more purposely incorporated than in our revenue laws. While the Internal Revenue Code [IRC]³ is fundamentally oriented toward the collection of the tax revenues, the tax laws also implement a myriad of goals having tenuous connection with the financing of our government. One of these objectives is the regulation of charities.

The national government does not directly prescribe laws regulating the establishment and operation of charities. This task is administered by the individual states.⁴ Congress does indirectly control these organizations, however, by granting substantial tax benefits upon their compliance with its legislative directives. These benefits are in two forms. First, charities that meet the requirements of section 501(c)(3) of the IRC are exempted from taxation of their income.⁵ Secondly, contributions to these qualifying charities are congressionally encouraged by allowing the donors to deduct them from their adjusted gross income.⁶ By making the carrot so tasty, Congress avoids the necessity of a stick.

Because of these tax concessions, it is economically desirable, if not imperative, for hospitals to qualify as tax exempt organizations. Section 501(a) exempts organizations described in section 501(c)(3) from

1. BLACK'S LAW DICTIONARY 1317 (4th ed. 1951).

2. *Id.*

3. INT. REV. CODE OF 1954.

4. See generally 4 A. SCOTT, THE LAW OF TRUSTS §§ 348-403 (3d ed. 1967).

5. INT. REV. CODE OF 1954, § 501(a) provides: "An organization described in subsection (c) or (d) or section 401(a) shall be exempt from taxation under this subtitle unless such exemption is denied under section 502 or 503."

6. *Id.* § 170.

taxation on income related to its exempt purposes.⁷ To qualify under the latter section, a hospital must meet the following requirements: (1) it must be organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or for the prevention of cruelty to children or animals; (2) no earnings of the hospital may benefit any private shareholder or individual; and (3) it must neither devote a substantial part of its activities toward influencing legislation nor engage in a political campaign.⁸ Health care organizations are generally exempted as charitable institutions.⁹

ORGANIZATIONAL AND OPERATIONAL TESTS

The regulations have created organizational and operational tests incorporating the above prescriptions. A hospital must meet both tests in order to earn its exemption.¹⁰ The first standard requires the charity to be organized exclusively for exempt functions.¹¹ This requirement obligates the articles of organization to restrict the mission of the organization to one or more of the exempt purposes specified in the statute and to avoid any express authorization of substantial activities not in furtherance of the exempt purposes.¹² The term "articles of incorporation" encompasses a trust instrument, a corporate charter, or any other written document by which the organization is established.¹³

7. *Id.* § 501(a). For a discussion of the taxation of an organization's income that is unrelated to its exempt purpose, see text accompanying notes 33-37, 39-42 *infra*.

8. INT. REV. CODE OF 1954, § 501(c)(3). The subsection provides:

(c) List of exempt organizations—The following organizations are referred to in subsection (a):

....

(3) Corporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual, no substantial part of the activities of which is carrying on propaganda, or otherwise attempting to influence legislation, and which does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of any candidate for public office.

9. See Rev. Rul. 56-185, 1956-1 CUM. BULL. 202. Of course, a teaching hospital could also apply for exempt status as an educational organization, but the hospital itself must provide the curriculum and instruction and not merely the facilities. *Cf.* *Harding Hosp., Inc. v. United States*, 505 F.2d 1068, 1076 (6th Cir. 1974). Furthermore, the exemption would cover only income resulting from its educational functions. Income relating solely to the provision of health care would not be exempted.

10. Treas. Reg. § 1.501(c)(3)-1(a)(1) (1969).

11. *Id.* -1(b).

12. *Id.* -1(b)(1)(i).

13. *Id.* -1(b)(2).

The writing will comply with the regulations if it contains a verbatim quotation of exempt purposes from the statute. A more detailed description of the objective and the manner of its attainment is also acceptable.¹⁴

An organization will fail the organizational test, however, if its articles authorize substantial activities of a non-exempt nature, regardless of whether the articles restrict the aim of the institution to those listed in the statute.¹⁵ Also, even though the actual functioning of the charity is in pursuit of its exempt purpose, the test is not met if the founding document permits substantial non-exempt functions.¹⁶ The articles must also refrain from authorizing substantial involvement in the influencing of legislation or participation in political campaigns.¹⁷ In addition, to prevent any noncharitable use of the assets of the organization, the articles must dedicate the assets exclusively to charity by providing that they be distributed for exempt purposes upon the dissolution of the organization. Under no circumstances may the assets be distributed to any shareholders of the charity, as this event would allow the inurement of retained earnings to a private individual.¹⁸

The second criterion for tax exempt status under section 501(c)(3) defines "operated exclusively" as engaged *primarily* in activities that promote charitable purposes. If more than an insubstantial portion of the institution's work is in non-exempt areas, the test is not met.¹⁹ Additionally, the standard does not allow the inurement of earnings to the benefit of private persons. In this regard, there appears to be no requirement of substantiality. If *any* earnings are available in whole or in part for the benefit of private individuals, the organization is not exclusively operated for charitable purposes.²⁰ Furthermore, the operational test denies an exemption to "action" organizations. These are groups that devote a substantial part of their activities to influencing legislation by propaganda or other means, or that intervene in any political campaign on behalf of or against any candidate for office.²¹

14. *Id.* -1(b)(1)(ii). In fact, a detailed statement of the projected activities of the organization must also be submitted with its application for exemption. *Id.* -1(b)(1)(v).

15. *Id.* -1(b)(1)(iii).

16. *Id.* -1(b)(1)(iv).

17. *Id.* -1(b)(3).

18. *Id.* -1(b)(4).

19. *Id.* -1(c)(1).

20. *Id.* -1(c)(2).

21. *Id.* -1(c)(3).

LIMITATIONS ON THE ORGANIZATIONAL TEST

As stated earlier, the organizational test is not met if the articles of organization authorize non-charitable activities, although the actual operation of the institution is restricted to a permitted purpose. Some courts have shown a reluctance to enforce this regulation literally. In *John Danz Charitable Trust*,²² for example, the Tax Court held a trust exempt when the trust instrument specifically empowered the trustees to engage in non-exempt functions, but the powers had not been exercised. In a later decision the Tax Court held that when the trust instrument specifically provides that the purpose of the trust is charitable, the court can assume that the trustees will not exercise any other authorized powers if such powers would violate the overall charitable purpose.²³

Contrary to the above line of thought, the Second Circuit rejected the argument that a trustee of an allegedly exempt trust was only empowered, and not required, to draft legislation to effect the purposes of the trust. These purposes included the abolition of capitalism and the advancement of civil liberties. The court felt that they could be accomplished only by legislation and were in themselves political and therefore non-exempt.²⁴

Thus, it is not entirely certain that the organizational test will be overlooked. Many courts quote it *in toto* without comment. At a minimum, a court must be convinced that the undesirable powers will not be exercised before the test will be disregarded. On the other hand, the organizational test will generally not present insurmountable problems to an operating hospital. With regard to future earnings, any deficiency in the corporate charter can be cured by amendment. Trouble will therefore primarily arise when an exemption for income earned in previous taxable years is disallowed, as charter amendments will not have retroactive effect.

LIMITATIONS ON THE OPERATIONAL TEST

At one time the Commissioner of Internal Revenue [Commissioner] contended that the conduct of a business by a charitable institution violated the requirement of exclusive operation for exempt

22. 32 T.C. 469 (1959), *aff'd*, 284 F.2d 726 (9th Cir. 1960). See also *Elisian Guild, Inc. v. United States*, 412 F.2d 121 (1st Cir. 1969).

23. *Waller v. Commissioner*, 39 T.C. 665, 673 (1963).

24. *Marshall v. Commissioner*, 147 F.2d 75 (2d Cir. 1945).

purposes. In *Trinidad v. Sagrada Orden de Predicadores*,²⁵ however, the United States Supreme Court held that commercial trading by a charity is permissible if it is incidental to the pursuit of the exempt purpose. The expenditure of the income rather than its production is therefore the focal point.²⁶

Today the regulations recognize this distinction and incorporate it into the organizational test.²⁷ The basic problem in its application is the determination of whether the primary purpose of the organization is to engage in the trade or business or to further its charitable purposes.²⁸ If the trade or business is undertaken in pursuit of the exempt purposes, the exemption is valid. This determination is a factual one in which the size and extent of the commercial business is contrasted with that of the exempt activities.²⁹ Courts generally employ a monetary test, comparing sales collected in the trade with amounts expended on the charitable programs. A large accumulation of profits is fatal to the exemption.³⁰

For most operating health care institutions, these requirements provide no insurmountable obstacle. While the operation of a hospital does constitute a trade or business, this enterprise is inseparable from the performance of its exempt function.³¹ Of course, no hospital should accumulate vast amounts of profits, unless they are used in expanding facilities and improving health care.³²

Notwithstanding the incidental status of the business, the Supreme Court in *Trinidad* recognized the possibility of an unfair competitive advantage enjoyed by charities over their non-exempt commercial ri-

25. 263 U.S. 578 (1924).

26. *Id.* at 581. See also *St. Louis Union Trust Co. v. United States*, 374 F.2d 427 (8th Cir. 1967); *Stevens Bros. Foundation v. Commissioner*, 324 F.2d 633, 638 (8th Cir. 1963), *cert. denied*, 376 U.S. 969 (1964); *Passaic United Hebrew Burial Ass'n v. United States*, 216 F. Supp. 500, 505 (D.N.J. 1963); *Lewis v. United States*, 189 F. Supp. 950 (D. Wyo. 1961).

27. Treas. Reg. § 1.501(c)(3)-1(c)(1) (1959); *id.* -1(e) (1967).

28. *Id.* -1(e) (1967).

29. *Id.*

30. See, e.g., *Elisian Guild, Inc. v. United States*, 412 F.2d 121 (1st Cir. 1969); *People's Educ. Camp Soc'y, Inc. v. Commissioner*, 331 F.2d 923 (2d Cir. 1964); *Passaic United Hebrew Burial Ass'n v. United States*, 216 F. Supp. 500 (D.N.J. 1963); *Scripture Press Foundation v. United States*, 285 F.2d 800 (Ct. Cl. 1961), *cert. denied*, 368 U.S. 985 (1962); *Edward Orten, Jr., Ceramic Foundation*, 56 T.C. 147 (1971).

31. *Davis Hosp., Inc.*, P-H Tax Ct. Mem. ¶ 45,097 at 45-344 (1945); *Goldsby King Memorial Hosp.*, P-H Tax Ct. Mem. ¶ 44,233 at 44-757 (1944); Rev. Rul. 56-185, 1956-1 CUM. BULL. 202. For purposes of this discussion, the reader may assume that the exempt function of hospitals is the provision of health care coupled with some degree of charitable aid to indigent patients. For a full discussion of the exempt function of a hospital, see text accompanying notes 43-85 *infra*.

32. Rev. Rul. 56-185, 1956-1 CUM. BULL. at 203.

vals.³³ Exempt organizations could expand operations with tax-free profits, while their competitors could not. As a remedy, Congress enacted a tax on profits derived by charities in commercial transactions.³⁴ With certain exceptions, section 511 imposes an income tax on the "unrelated business taxable income" of section 501(c)(3) organizations, including health care institutions.³⁵ Section 512 defines "unrelated business taxable income" as the gross income from an "unrelated trade or business" *regularly* conducted by the charity, less deductions for expenses connected with the trade or business.³⁶ An "unrelated trade or business" is one whose operation is *not substantially related* to the performance of the charity's exempt function. The mere need for income to support the charitable activities is not a substantial connection.³⁷

These sections mean that when a hospital generates income from the furnishing of health care to its own patients, no tax will be imposed, because the income is clearly related to the exempt functions.³⁸ However, the income from services rendered to others on a continuous basis will be subject to the tax.³⁹ For example, if a hospital maintains a pharmacy that regularly sells prescription drugs to the general public, the income will constitute "unrelated business taxable income."⁴⁰ If such sales occur infrequently as a courtesy to the private patients of its medical staff, there is no *regularly* conducted unrelated business and thus no tax.⁴¹ Furthermore, many services not directly connected with health care, but necessary for the operation of a hospital, are not "unrelated businesses" if provided solely for patients, employees, and visitors. These activities include the operation of a cafeteria, a gift shop, and a parking lot. The Commissioner has determined that there is a sufficient relationship between the furnishing of these services and the provision of health care to prevent the imposition of a tax.⁴²

33. See 263 U.S. at 582.

34. See 6 J. MERTENS, *THE LAW OF FEDERAL INCOME TAXATION* § 34.14a, at 84-85 (1975); Treas. Reg. § 1.513-1(b) (1975).

35. See INT. REV. CODE OF 1954, § 511.

36. *Id.* § 512. This definition is subject to modifications specified in section 512(b).

37. *Id.* § 313(a).

38. See *id.*; Rev. Rul. 68-376, 1968-2 CUM. BULL. 246.

39. See INT. REV. CODE OF 1954, § 513.

40. Rev. Rul. 68-375, 1968-2 CUM. BULL. 245; Rev. Rul. 68-374, 1968-2 CUM. BULL. 242.

41. Rev. Rul. 68-374, 1968-2 CUM. BULL. 242.

42. See Rev. Ruls. 69-267 to -269; 1969-1 CUM. BULL. 160. See also Rev. Rul. 69-463, 1969-2 CUM. BULL. 131.

REQUISITES OF AN EXEMPT FUNCTION

Section 501(c)(3) lists the following purposes as qualifying for exemption: religious, charitable, scientific, testing for public safety, literary, educational, and prevention of cruelty to children or animals.⁴³ Further, the section provides that the organization must serve a public and not a private interest in the attainment of these goals.⁴⁴

A health care institution must qualify, if at all, as a charitable organization.⁴⁵ The regulations provide that the term "charitable" is to be interpreted according to its "generally accepted legal sense."⁴⁶ According to the regulations, this meaning embraces "[r]elief of the poor and distressed"; promotion of religion, education, or science; construction of public buildings, monuments, or works; "lessening of the burdens of Government;" and advancement of social welfare.⁴⁷ The provision of health care is not specifically included. In granting charitable status, the Internal Revenue Service [IRS] has traditionally required that hospitals do more than just generally provide health care.

Prior to 1956, the IRS contended that exemption as a charitable organization should be denied when a hospital charged for its services. Even financially solvent patients had to be provided free care for the hospital to qualify under 501(c)(3). Clearly, the cost of patient treatment could not be met today through governmental grants and private donations alone. To require hospitals to furnish all care without charge would render impossible the charitable services they presently perform. Quite correctly, the United States Court of Appeals for the Fifth Circuit and the Tax Court both rejected this position.⁴⁸ At the same time, these courts noted that exempt status required admission and treatment of those unable to pay.⁴⁹

In a 1956 revenue ruling,⁵⁰ the IRS enunciated the requirements that a hospital must meet to constitute a public charitable organization. Such classification, according to the IRS, "contemplate[d] an implied

43. INT. REV. CODE OF 1954, § 501(c)(3). See note 8 *supra* for text.

44. Treas. Reg. § 1.501(c)(3)-1(d)(1)(ii) (1959).

45. *Id.* -1(d)(1)(ii); see note 9 *supra*.

46. Treas. Reg. § 1.501(c)(3)-1(d)(2) (1959).

47. *Id.*

48. *Commissioner v. Battle Creek, Inc.*, 126 F.2d 405 (5th Cir. 1942); *Davis Hosp., Inc.*, P-H Tax Ct. Mem. ¶ 45,097 at 45-344 (1945).

49. *Commissioner v. Battle Creek, Inc.*, 126 F.2d at 406; *Davis Hosp., Inc.*, P-H Tax Ct. Mem. ¶ 45,097 at 45-348 (1945).

50. Rev. Rul. 56-185, 1956-1 CUM. BULL. 202.

public trust constituted for some public benefit."⁵¹ To qualify, the institution first had to be "organized as a non-profit charitable organization for the purpose of operating a hospital for the care of the sick." Secondly, "to the extent of its financial ability," the hospital had to provide services free of charge to indigents.⁵² At the same time, it was allowed to charge those able to pay. A relatively low charity record was acceptable "in the absence of charitable demands of the community,"⁵³ and charity could be rendered by providing services at reduced rates. The generation of profits and their use in improving hospital facilities were also considered proper. However, mere acquiescence by the hospital in the failure of some patients to pay for services rendered was insufficient charitable activity, if the hospital operated with the expectation of full payment by all patients.⁵⁴

In *Robert C. Olney*,⁵⁵ a 1958 case, the Tax Court held that the hospital in question was exempt from taxation since it conformed to the dictates of the above ruling. The court found that the hospital had not denied treatment to any patient because of his indigency and that no investigation was made concerning a patient's ability to pay upon application for admission. On the contrary, the court found that many were admitted with the hospital's knowledge of their indigency.⁵⁶

Later the Tax Court cited the 1956 revenue ruling in denying tax exemptions. Holding that the mere operation of a hospital did not automatically constitute a charitable activity, the court in *Sonora Community Hospital*⁵⁷ held that the provision of gratuitous services to impoverished patients was a necessary supplement.⁵⁸ The court declared that the hospital had failed to hold itself out to the public as a charitable institution and had rendered free care on a de minimis level—less than one percent of compensated care.⁵⁹ Again, the court in *Maynard Hospital, Inc.*,⁶⁰ in denying an exemption, noted the low amount of work performed without remuneration. The fact that the hospital did not refuse admission to indigents and often cancelled unpaid bills was

51. *Id.* at 1956-1 CUM. BULL. 203.

52. *Id.* (emphasis added).

53. *Id.* at 1956-1 CUM. BULL. 204.

54. *Id.* at 1956-1 CUM. BULL. 203.

55. P-H Tax Ct. Mem. ¶ 58,200 at 58-849 (1958).

56. *Id.* at 58-855.

57. 46 T.C. 519 (1966), *aff'd per curiam*, 397 F.2d 814 (9th Cir. 1968).

58. *Id.* at 525-26.

59. *Id.* at 526.

60. 52 T.C. 1006 (1969).

not sufficient, as the court found that the institution expected compensation for all services.⁶¹

In 1969 there was a dramatic shift in the position of the IRS. Many hospital representatives had claimed that they should be classified in the same manner as educational and scientific organizations, that is, as charitable institutions, regardless of their philanthropic performance. In response, Revenue Ruling 69-545 was issued. It allowed an exemption if the articles of organization of a hospital limited the institution to charitable purposes, if the hospital operated a full-time emergency room that was available to all requiring emergency care without regard to ability to pay, and if it provided health services to those able to pay (including Medicare patients). If these criteria were met, a hospital was to be viewed as charitable, even though it ordinarily limited its admissions to financially solvent patients or Medicare recipients and referred others to community hospitals that performed gratuitous services.⁶²

Thus, with minor qualification, the IRS finally agreed that the promotion of health was per se a charitable purpose and should be deemed beneficial for the entire community, even if certain segments of the community such as indigents were excluded. By operating an emergency room open to all, by providing health services to those able to pay, and by treating Medicare and Medicaid patients, a hospital was considered to be promoting the health of a class of persons that was "broad enough to benefit the community."⁶³

In 1974 a Kentucky welfare organization sought to prevent the use of Revenue Ruling 69-545 in qualifying hospitals as charities. It contended that the failure of the new ruling to require treatment of indigents was contrary to congressional intent and to relevant judicial, legislative, and administrative history on the matter. In *Eastern Kentucky Welfare Rights Organization v. Simon*, the Court of Appeals for the District of Columbia Circuit rejected these contentions and upheld the 1969 ruling.⁶⁴

According to the court, the word "charitable," as used in the Treasury regulations, permitted a definition far broader than mere aid to indigent members of society. The concept of health care was included

61. *Id.* at 1026-27.

62. Rev. Rul. 69-545, 1969-2 CUM. BULL. 117, 118.

63. *Id.* at 1969-2 CUM. BULL. 118.

64. 506 F.2d 1278 (1974). The Supreme Court vacated and remanded to the district court, finding that plaintiffs lacked standing. 44 U.S.L.W. 4724 (U.S. June 1, 1976).

within the definition.⁶⁵ While hospitals were once "almshouses supported by philanthropy providing care primarily for the poor," the soaring costs of medical care and the growing use of hospitals by all segments of society had radically changed the nature of the institution. Furthermore, the growth of Medicare and Medicaid had eliminated the requirement of much of the populace for free hospitalization.⁶⁶

The court noted that under the 1956 ruling, which required the rendering of free services only to the extent of a hospital's financial ability, a hospital operating at a deficit had no obligation to the poor. The 1969 ruling, however, required a hospital to provide services to indigents in the form of free emergency care; this requirement was without qualification. Also, the 1969 ruling required the acceptance of Medicare and Medicaid patients to obtain exempt status. On these bases, the court suggested that the 1969 ruling provided greater benefit to the poor than did its predecessor.⁶⁷ It concluded the ruling was a proper interpretation of the term "charitable" as used in section 501(c)(3) and the regulations.⁶⁸

The Supreme Court granted certiorari in this case but failed to reach the question of the validity of Revenue Ruling 69-545.⁶⁹ Thus, this issue is yet to be resolved. However, a subsequent opinion by the United States Court of Appeals for the Sixth Circuit has questioned whether mere compliance with the 1969 Revenue Ruling will be sufficient to obtain a tax exemption.⁷⁰ In *Harding Hospital, Inc. v. United States*,⁷¹ the denial of an exemption was based upon the failure of the hospital to hold itself out to the public as a charitable institution, the lack of public donations to the hospital, and the failure of the hospital to establish a specific plan or policy for the treatment of charity patients.⁷² Although uncompensated services ranged between four and almost eight percent of its revenue, the hospital treated patients as charitable cases only after their funds were exhausted.⁷³

The opinion does not indicate whether there was emergency room service for all persons regardless of financial status, but the type of

65. *Id.* at 1287, citing RESTATEMENT (SECOND) OF TRUSTS § 368 (1959); 4 A. SCOTT, THE LAW OF TRUSTS § 368 (3d ed. 1967).

66. 506 F.2d at 1288.

67. *Id.* at 1289.

68. *Id.* at 1290.

69. See note 64 *supra*.

70. *Harding Hosp., Inc. v. United States*, 505 F.2d 1068 (6th Cir. 1974).

71. *Id.*

72. *Id.* at 1077.

73. *Id.*

psychiatric treatment exclusively rendered by the hospital implied that an emergency facility was not necessary for medical purposes.⁷⁴ Thus, it is not clear that the failure to establish a specific plan or policy for the treatment of charity patients would constitute a ground for a denial of a section 501(c)(3) exemption when an emergency room is provided. The court specifically declined to determine whether emergency treatment alone is sufficient.⁷⁵

It should be noted that the court did not rule on the validity of the 1969 ruling but assumed that its validity would not alter its holding.⁷⁶ Yet Revenue Ruling 69-545 does not require any specific plan beyond the furnishing of emergency services to indigents, a service probably not required for medical reasons in this instance. Rather than reconcile the above confusion, the opinion discussed two other psychiatric institutions that operated a community health center and a ghetto clinic, both of which rendered gratuitous care to indigents. The court felt that these clinics satisfied its requirement of a specific plan.⁷⁷ Such a requirement, totally unrelated to the treatment method of Harding Hospital, would be an unjustifiable financial burden to that institution, considering the policy behind Revenue Ruling 69-545.

Consequently it is not entirely clear to what extent free medical services must be provided or how important the provision of free services is as a single factor in determining exemptions under section 501(c)(3). Certainly, other tests, such as prohibition of private benefit from the revenues of the hospital, must be met.⁷⁸ Probably, as the possibility of private utilization becomes increasingly suspicious, the more stringently indigent services may be scrutinized to determine whether the hospital serves a public function. As to what amount of free hospitalization must be provided, free emergency care is a minimum. When this care is not required by the specialized medical pursuits of the hospital, some specific plan for poor relief may be required as a substitute. The opinion in *Harding Hospital* also indicates there may be a further obligation for the hospital to represent itself to the public as a charitable organization for the purposes of receiving donations and

74. See *id.* at 1070. The hospital treated mental and nervous diseases by a method known as milieu therapy. Under this treatment, the total environment of the patient is continually controlled with the goal of rehabilitation. *Id.*

75. *Id.* at 1078 n.2.

76. *Id.* at 1076.

77. *Id.* at 1077-78.

78. See text accompanying notes 80-105 *infra*.

advertising the free services provided.⁷⁹

PUBLIC VS. PRIVATE BENEFIT

Section 501(c)(3) requires that no part of the earnings of an exempt organization inure to the benefit of private persons.⁸⁰ The regulations further require that the assets of an organization be dedicated to an exempt purpose. Thus, its articles must require that upon dissolution of the organization the assets be distributed for exempt purposes, and must prevent any part of them from reverting to private individuals.⁸¹ There is an absolute prohibition of any private enrichment derived from the earnings.

Furthermore, the regulations require that an organization serve a public rather than a private interest.⁸² In this requirement there is more leeway. Unlike the total prohibition against private receipt of earnings, the directive of public benefit does allow some form of private betterment under limited circumstances. First, the benefit must flow principally to the public. The private benefit must be relatively small and incidental to or inseparable from the public benefit. Next, the presence of private benefit must create no conceivable threat of detriment to the public's interest.⁸³

Thus, tax benefits to the creator of a charity may be permissible even though they are derived from dealings between the creator and the charity. In Revenue Ruling 69-39,⁸⁴ the creator sold securities to a charitable trust at an amount equal to his cost. The fair market value of the stock exceeded its cost, and the trust resold the stock at a profit. The creator then took a charitable deduction for the difference between the

79. 505 F.2d at 1077.

80. INT. REV. CODE OF 1954, § 501(c)(3). See note 8 *supra* for the text of the section.

81. Treas. Reg. § 1.501(c)(3)-1(b)(4) (1969).

82. *Id.* -1(d)(1)(ii).

83. See, e.g., Rev. Rul. 70-186, 1970-1 CUM. BULL. 128 (exemption upheld when improvements to lake by exempt organization benefited its donors as well as the public. The donors were lake front property owners, but the lake was used primarily by the public.); Ginsberg v. Commissioner, 46 T.C. 47 (1966) (exemption denied on facts similar to those in Rev. Rul. 70-186. In this case the improved waterway was used almost entirely by the donors of the exempt organization.); Rev. Rul. 66-358, 1966-2 CUM. BULL. 218 (exemption permitted when corporation donated land which was run by the exempt organization as a public park. The corporation retained the right to use a scene in the park as its brand symbol. The Commissioner viewed the benefit to the corporation as incidental to that received by the general public.). See also cases cited note 85 *infra* (tax benefits to private individuals).

84. 1969-1 CUM. BULL. 148.

fair market value and the cost of the stock. These transactions were held permissible, since the creation of the charitable deduction was not the primary function of the charity, and there was no risk of investment loss to the charity.⁸⁵

An exemption, however, will be denied if formation of the organization is fundamentally an attempt to reduce the federal income taxes of its creator. In Revenue Ruling 69-266,⁸⁶ a doctor formed an allegedly charitable organization whose activities consisted of treating patients for compensation. Its creator was employed to provide these services in return for an adequate salary and rather desirable fringe benefits. The Commissioner correctly observed that the organization did not significantly differ from the private practice of medicine.⁸⁷

For hospitals, problems with the prohibition of benefit to private persons have primarily involved hospital income and restricted staff memberships.⁸⁸ The first involves the channeling of hospital income to founding or managing doctors. One method is the payment of excessive salaries. This device is specifically prohibited by Revenue Ruling 56-185.⁸⁹ However, the payment of compensation for services rendered by doctors should not be fatal if the amounts are reasonable.⁹⁰ The determination of this question of fact depends upon the qualifications of the officer or doctor, the nature of the service rendered, the responsibilities of the position assumed, and the remuneration paid by competitors for comparable positions.⁹¹ The burden of proof is upon the charity.⁹²

If the salary is paid to a doctor who founds or manages the hospital, there is very close scrutiny of the transaction. Misappropriation of a hospital's funds by its creator for his personal expenses, as in

85. *Id.*; see, e.g., *Elisian Guild, Inc. v. United States*, 412 F.2d 121, 125-26 (1st Cir. 1969); *Commissioner v. Teich*, 407 F.2d 815, 816 (7th Cir. 1969); *Waller v. Commissioner*, 39 T.C. at 676-77.

86. 1969-1 CUM. BULL. 151.

87. *Id.*

88. Section 503 denies exemptions to organizations engaging in certain prohibited transactions that result in private benefit. Hospitals are, however, exempted from these restrictions by section 503(b)(5). INT. REV. CODE OF 1954. At the same time, hospitals remain subject to all other restrictions on private benefit. *Kenner v. Commissioner*, 318 F.2d 632, 635-36 (7th Cir. 1963).

89. 1956-1 CUM. BULL. 202, 203; accord, *Mabee Petroleum Corp. v. United States*, 203 F.2d 872, 876 (5th Cir. 1953).

90. See *Home Oil Mill v. Willingham*, 68 F. Supp. 525 (N.D. Ala. 1946).

91. See *Jones Bros. Bakery, Inc. v. United States*, 411 F.2d 1282, 1291 (Ct. Cl. 1969).

92. *Kenner v. Commissioner*, 318 F.2d 632, 635 (7th Cir. 1963).

Kenner v. Commissioner,⁹³ is a clear violation of section 501(c)(3). Also, payment of salaries that are determined as a percentage of hospital or laboratory receipts is highly suspect. If the amounts paid are large, it will be difficult to establish that medical services of equal value were rendered.⁹⁴ In the Commissioner's view, such methods of compensation may render the primary purpose of the hospital a joint business venture between the hospital and the physicians in control rather than the rendering of health care.⁹⁵ On the other hand, if such a compensation agreement is determined after arm's length negotiations between a doctor and an independent hospital, the result may differ—provided that the payments are not excessive.⁹⁶

Sometimes large payments for hospital supervision to doctors who are closely related with the establishment or control of the institution are considered a private benefit, even if comparable services were rendered. In *Harding Hospital* the court concluded that compensation for hospital supervision paid to a medical partnership (which also provided all of the institution's medical care) was an instance of private benefit.⁹⁷ The hospital had contended the expenditure was in lieu of employing a salaried medical doctor. Although the court assumed that the expenditure was valid, it still believed the medical partnership received substantial benefit from the agreement.⁹⁸ On the whole, this conclusion appears incorrect, if the court actually believed that adequate services were provided. If mere employment of a doctor in control of the hospital will be regarded as an impermissible instance of private benefit, small hospitals may have the burden of employing unnecessary personnel.

Certain business transactions between the controlling doctors and the hospital may void the exemption. In *Maynard Hospital, Inc.*,⁹⁹ a pharmacy owned by the hospital was transferred to a corporation owned by the trustees of the hospital. The pharmacy bought drugs under the hospital's name, thereby obtaining purchase discounts, and then sold the drugs to the hospital at a price ten percent greater than the hospital could have obtained by purchasing directly. The court properly found this device to be a method of channeling hospital revenues to its

93. *Id.* at 634-35.

94. *Cf. Sonora Community Hosp. v. Commissioner*, 46 T.C. 519, 526-27 (1966).

95. Rev. Rul. 69-383, 1969-2 CUM. BULL. 113.

96. *Id.*

97. 505 F.2d at 1078.

98. *Id.*

99. 52 T.C. 1006 (1969).

trustees.¹⁰⁰ Rental of office space, equipment, and business office services at less than fair market value by the hospital to its medical staff is also considered to be operation for the benefit of private individuals.¹⁰¹

A hospital is also prohibited from restricting the use of its facilities to a limited group of physicians.¹⁰² This practice is perceived by the Commissioner as a violation of the "public service concept inherent in section 501(c)(3)."¹⁰³ The facilities of a charitable institution should be open to the community. Subject to space limitations, all local doctors should be allowed use of the facilities. Restricted use also creates an advantageous economic interest in the staff doctors. Even in a case in which staff membership was open to any physician who wished to practice at the hospital,¹⁰⁴ the Sixth Circuit Court of Appeals has held that there was private benefit because ninety to ninety-five percent of the treatment at the hospital was performed by a medical corporation whose membership was restricted. The corporation was viewed to have substantial benefit merely because of its "virtual monopoly" of the hospital's patients.¹⁰⁵

PROHIBITION OF POLITICAL ACTIVITY

Since 1954 the Internal Revenue Code has enjoined exempt organizations from devoting a "substantial" portion of their activities to the dissemination of "propaganda," from "otherwise attempting to influence legislation," and from participating in a political campaign for public office on behalf of any candidate.¹⁰⁶ The proscription of propaganda and legislative influence was added by the Revenue Act of 1934¹⁰⁷ as a congressional response to a Second Circuit opinion written by Judge

100. *Id.* at 1028-29.

101. *Harding Hosp., Inc. v. United States*, 505 F.2d 1068, 1078 (6th Cir. 1974); Rev. Rul. 69-545, 1969-2 CUM. BULL. 117, 118; Rev. Rul. 56-185, 1956-1 CUM. BULL. 202, 203.

102. *Harding Hosp., Inc. v. United States*, 505 F.2d 1068, 1078 (6th Cir. 1974); Rev. Rul. 69-545, 1969-2 CUM. BULL. 117, 118; Rev. Rul. 56-185, 1956-1 CUM. BULL. 202, 203.

103. Rev. Rul. 56-185, 1956-1 CUM. BULL. 202, 203.

104. *Harding Hosp., Inc. v. United States*, 358 F. Supp. 805, 813-14 (S.D. Ohio 1973), *aff'd*, 505 F.2d 1068 (6th Cir. 1974).

105. 505 F.2d at 1078.

106. INT. REV. CODE OF 1954, § 501(c)(3). See note 8 *supra* for the text of the subsection.

107. Ch. 216, § 101, 48 Stat. 680, 700.

Learned Hand.¹⁰⁸ In this case, *Slee v. Commissioner*,¹⁰⁹ an exemption was denied the American Birth Control League. The League maintained a clinic in New York City, where it aided married women in preventing conception. But the League also agitated for the repeal and amendment of state and federal statutes dealing with birth control. While the operation of the clinic was a charitable activity, the court ruled that because of its legislative activity, the League was not organized and operated *exclusively* for exempt purposes, and thus did not qualify as "charitable" under the statute.¹¹⁰

The statutory enactment of the *Slee* doctrine in section 501(c)(3) has created several new issues. First, what is "substantial" activity? The *Slee* opinion did not condone even the most minute amount of legislative activity.¹¹¹ The only court ruling since the codification held that five percent is not substantial.¹¹² Secondly, what does "propaganda" or otherwise influencing legislation mean? Judge Hand distinguished between education (which is exempt) and the attempt to secure the acceptance of beliefs by the public (which, constituting propagandizing, is not exempt).¹¹³ The opinion in *Seasongood v. Commissioner*¹¹⁴ discussed the divers sentiments on the issue held by the various members of the Sixth Circuit. The author of the opinion felt that propaganda is communication that has a harmful, selfish purpose and is inaccurate or biased in a manner calculated to achieve such purposes. Other members believed that mere dissemination of a particular belief or opinion in an attempt to influence public opinion is sufficient to constitute propaganda.¹¹⁵ The latter definition appears to be the majority approach.¹¹⁶ It would then follow that the prohibition applies to attempts to influence legislation indirectly by molding public opinion, as well as directly

108. *Slee v. Commissioner*, 42 F.2d 184 (2d Cir. 1930). See *Cammarano v. United States*, 358 U.S. 498, 512 (1959).

109. 42 F.2d 184 (2d Cir. 1930).

110. *Id.* at 185.

111. *Id.*

112. *Seasongood v. Commissioner*, 227 F.2d 907 (6th Cir. 1955).

113. 42 F.2d at 185.

114. 227 F.2d 907 (6th Cir. 1955).

115. *Id.* at 909-11.

116. See, e.g., *Christian Echoes Nat'l Ministry, Inc. v. United States*, 470 F.2d 849, 854 (10th Cir. 1972) (motive for engaging in propaganda is immaterial); *League of Women Voters v. United States*, 180 F. Supp. 379 (Ct. Cl.), *cert. denied*, 364 U.S. 822 (1960); Note, *The Sierra Club Controversy*, 55 CALIF. L. REV. 618 (1967); cf., e.g., Rev. Rul. 74-117, 1974-1 CUM. BULL. 128; Rev. Rul. 67-71, 1967-1 CUM. BULL. 125. But see *League of Women Voters*, *supra*, at 384 (Jones, C.J., dissenting).

by lobbying.¹¹⁷ Thirdly, what acts constitute influencing legislation? In *League of Women Voters v. United States*,¹¹⁸ the League contacted legislators and public officials to promote the political goals adopted in its annual platform. This platform was the result of deliberations of members at the local, state, and national levels of the League. While the court found that very little effort went into actual correspondence with legislators, it still ruled that the organization was not operated for exempt purposes because of substantial political activity. Within the definition of lobbying, the court included the deliberation on and adoption of the platform, both before and at the national convention at which it was adopted. These activities, of course, accounted for a significant portion of the League's travail.¹¹⁹

Slee, however, distinguished legislative activity that was ancillary to the charitable purpose which remained the exclusive goal.¹²⁰ As examples, Judge Hand cited lobbying for appropriations by a state university, lobbying for legislation granting a special charter needed for certain charitable purposes, or lobbying for permission to teach evolutionary biology in Tennessee by a university of that state.¹²¹ A number of courts have relied upon this ancillary activity dictum to justify a permissive standard.¹²²

This approach, however, is a very treacherous foundation upon which to build a tax exemption. Too often the doctrine has been utilized by judges primarily as a boilerplate to justify their foregone conclusions based upon their own subjective standards. It seems that the doctrine will appear in an opinion only when the legislative goals of the organizations are in public favor.¹²³ *Lord's Day Alliance v. United*

117. See, e.g., *Cammarano v. United States*, 358 U.S. 498, 504-05 (1959); *Christian Echoes Nat'l Ministry Inc., v. United States*, 470 F.2d 849, 854-55 (10th Cir. 1972); *American Hardware & Equip. Co. v. Commissioner*, 202 F.2d 126 (4th Cir. 1953); *Roberts Dairy Co. v. Commissioner*, 195 F.2d 948 (8th Cir. 1952).

118. 180 F. Supp. 379 (Ct. Cl. 1960).

119. *Id.* at 383.

120. 42 F.2d at 185.

121. *Id.*

122. See Note, *The Revenue Code and a Charity's Politics*, 73 YALE L.J. 661, 667 n.25 (1964).

123. Cf., e.g., *International Reform Fed'n v. District Unemployment Compensation Bd.*, 131 F.2d 337 (D.C. Cir. 1942) (exemption upheld when organization sponsored legislation for prohibition of gambling, prostitution, harmful drugs and alcohol, etc.); *Girard Trust Co. v. Commissioner*, 122 F.2d 108 (3d Cir. 1941) (exemption upheld when objects of organization included passage of temperance legislation); *Slee v. Commissioner*, 42 F.2d 184 (2d Cir. 1930) (exemption denied when objects of organization were to provide birth control methods to patients through its clinic and to modify legislation restricting use of contraceptives); *Lord's Day Alliance v. United States*, 65 F.

*States*¹²⁴ and *Old Colony Trust Co. v. Welch*¹²⁵ serve as examples. In the former case the allegedly exempt group was organized to promote legislation to observe the Sabbath. In the latter, the goal of the organization was to enforce by litigation and legislation the separation of church and state. As to the first group, a federal district court in Pennsylvania viewed its purposes to be charitable and its legislative attempts to be necessary and ancillary to the accomplishment of those purposes. As to the second group, a district court in Massachusetts ruled that its activities were political in nature and non-exempt. One would think that the enforcement of the liberties of the United States Constitution would be of sufficient public benefit to merit charitable status. All Americans have an interest in those liberties. All do not have a stake in Sunday blue laws. Nor does it appear that recourse to political coercion is less critical to the prevention of mandatory prayer in the public schools than to the prevention of commercial activity on Sunday. In other cases, the exemptions have been upheld under the *Slee* dictum for organizations seeking passage of legislation prohibiting gambling, prostitution, harmful drugs, and liquor.¹²⁶ But the *Slee* case itself denied an exemption when the American Birth Control League sought to liberalize laws restricting the use of birth control devices. In this case, Judge Hand ruled that this activity was not ancillary to the operation of the clinic that dispensed contraceptives; yet, the purpose of the legal activity was to enlarge the conditions under which contraceptives could be prescribed. Although not conclusive proof, these cases illustrate the flexibility of the dictum, which can operate as a potential source of judicial discrimination.

As a general rule, the prohibition of political activity does not obstruct the proper management of hospitals. Unlike many educational groups, a hospital is apolitical in nature. However, there are many instances in which hospital authorities will perceive that their institutions' interests are involved in or threatened by legislative proposals or judicial decisions. These instances could include legislation limiting recoveries in medical malpractice suits, regulating the operation of hospitals, relating to abortion or euthanasia, or establishing national

Supp. 62 (E.D. Pa. 1946) (exemption upheld when organization sponsored legislation to protect the Sabbath); *Old Colony Trust Co. v. Welch*, 25 F. Supp. 45 (D. Mass. 1938) (exemption denied when goal of organization was to enforce constitutional separation of church and state through litigation and legislation).

124. 65 F. Supp. 62 (E.D. Pa. 1946).

125. 25 F. Supp. 45 (D. Mass. 1938).

126. See note 123 *supra*.

hospitalization insurance. Involvement by a hospital in the enactment process of any of the above legislation could seriously endanger its exemption. At the least it would raise such questions as whether the involvement was substantial activity or whether it was ancillary to the institution's exempt purpose. At present, the practice is for a hospital to belong to a national and a state association that obtain a consensus of opinion from their member hospitals on any given issue and present these views to the applicable legislative body. Thus, the institution itself is never involved in the lobbying.¹²⁷ It is also permissible for an official of a hospital to appear and testify before a legislative committee, if such testimony is given at the request of that committee.¹²⁸

Section 501(c)(3) also contains an absolute prohibition of involvement in a campaign for political office on behalf of a candidate.¹²⁹ Suffice it to say, any hospital that becomes openly involved in a political campaign has signed the death warrant of its tax exemption.

CONCLUSION

By this point, the omnipotent effect of the tax laws upon the operation of a hospital should be obvious. In summary, the major problems for hospitals seeking exempt status include tailoring the activities of the institution to comply with the legal definition of an exempt function and avoiding the aggrandizement of private individuals from the operation of the institution.

The pervasiveness of the influence possessed by the tax statutes upon charities raises a very fundamental question: should the tax laws be used to implement public policy unrelated to the collection of governmental revenues? The problem is that taxation requirements and considerations may significantly affect and alter the development of an independent area of the law. Development of the concept of charity should not be restricted by decisions necessary to prevent tax evasion. The political prohibitions placed upon charities are understandable only within the framework of the national tax scheme. For example, political activism is not incompatible with the concept of charity. The evil is the financing of political activity by governmental subsidy. Ideally, a charity should use the political process to foster its goals. As to the

127. Telephone interview with Paul Scopac, Ass't Administrator of Patient Services, Duke Hospital, Durham, N.C., Feb. 28, 1976.

128. Rev. Rul. 70-449, 1970-2 CUM. BULL. 111.

129. INT. REV. CODE OF 1954, § 501(c)(3). See note 8 *supra* for text.